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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1945

No. 264

IN THE MATTER

*of*

ST. CHARLES HOTEL COMPANY,

Debtor.

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EDWARD S. LADIN,

*Petitioner,*

HOWARD K. HURWITH, FRANK K. VIDLER; ABRAHAM H. KURZROCK; MAX N. CAROL, FIDELITY-PHILADELPHIA TRUST COMPANY, J. HENRY SCATTERGOOD, HALSTEAD RHODES, ALBERT A. LIEBERMAN; ST. CHARLES HOTEL COMPANY; AARON SMITH, TRUSTEE OF ST. CHARLES HOTEL COMPANY, Debtor; and SECURITIES AND EXCHANGE COMMISSION,

*Respondents.*

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Edward S. Ladin respectfully prays that a writ of certiorari issue to review the decree of the United States Circuit Court of Appeals for the Third Circuit entered on the 13th day of June, 1945, which affirmed three orders

of the United States District Court for the District of New Jersey, one entered on March 26, 1945, and two on April 30, 1945.

On December 8, 1944, the Debtor filed a petition for reorganization pursuant to Chapter X of the Bankruptcy Act (R. la, 5a). On motion of the respondents Howard K. Hurwith and Frank K. Vidler (R. 34a), creditors of the Debtor who filed answers to the Debtor's petition (R. la, 14a), the proceeding was dismissed on the ground that the petition was not filed in good faith (R. 90a). The order of March 26th dismissed the Debtor's petition (R. 90a), one of the April 30th orders denied the application of petitioner, a first mortgage bondholder, to reopen the proceedings (R. 109a) and the other, in part, directed the trustee, who had been previously appointed in this proceeding to turn over property of the Debtor in his possession (R. 111a).

In the lower court, petitioner was supported by the Securities and Exchange Commission and by other bondholders named as respondents herein.

## Opinions Below.

The opinion of the District Court (R. 71a) is reported in 60 F. Supp. 322. The *per curiam* opinion of the Circuit Court of Appeals is not yet reported.

## Jurisdiction.

The decree of the Circuit Court of Appeals was entered on June 13, 1945. Jurisdiction to issue the writ is found in the provisions of Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925; 28 U. S. C. 347(a).

## Questions Presented.

1. Was the petition of the Debtor for reorganization under Chapter X of the Bankruptcy Act filed in good faith?

2. Assuming that a corporation is in need of reorganization, must approval of a petition for its reorganization under Chapter X be denied because when such petition is filed there is pending, in a state court, an equity receivership proceeding and indirectly, through the use of the remedies afforded by that proceeding, a reorganization could be effected although the prior proceeding will not better serve the interests of creditors and stockholders?

3. In the situation described in the preceding question, must approval of the petition be denied unless the petitioner proves (1) that the prior state court proceeding is inadequate and (2) specifically that the interests of creditors and stockholders would be better served in a proceeding under Chapter X?

4. May a corporation which is in need of reorganization or its creditors elect reorganization under Chapter X even though there is pending a prior state court proceeding which affords similar relief but which will not better serve the interests of creditors and stockholders?

5. Does the circumstance that a Debtor's liabilities greatly exceed its assets (suppose its debts are three or four times its assets) make it unreasonable to expect that a plan of reorganization can be effected, if the Debtor is functioning as a going concern and is making a profit before interests on its fixed obligations?

## Statutes Involved.

The pertinent sections of Chapter X of the Bankruptcy Act (52 Stat. 883; 11 U. S. C. 501 *et seq.*) and of the General Corporation Act of New Jersey (Title 14, Chapter 14 Revised Statutes of New Jersey 1937, N. J. S. A. 14:14) because of their length, are set forth in the appendix to this petition.

## Statement.

The Debtor, a New Jersey corporation, is the owner of the St. Charles Hotel in Atlantic City, New Jersey (R. 5a, 23a). It has a capital of 10,000 shares of common stock of no par value and 4,520 shares of preferred stock of the par value of $100 (R. 12a).

As of May 1, 1925, it authorized the issue and sale of $3,000,000 principal amount of First Mortgage Bonds (R. 23a); there are now outstanding bonds in the principal amount of $2,228,000 which are widely held by the investing public in various states (R. 6a).[1] The bonds are secured by a first mortgage upon the hotel, its furniture, furnishings and equipment, under a trust indenture made with Franklin Trust Company of Philadelphia as trustees (R. 24a). In October 1931, Franklin Trust Company became insolvent and was taken over for liquidation by the Secretary of Banking of the Commonwealth of Pennsylvania. No successor indenture trustee has been appointed (R. 25a).

The bonds, which matured on May 1, 1945, bear interest at the rate of 6½% per annum, but no interest has been paid since May 1932 and accrued, unpaid interest exceeds $2,000,000 (R. 6a, 24a).

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[1] Petitioner is a resident of New York and among the respondents are bondholders who reside in New Jersey, Pennsylvania and Illinois.

Harry L. Katz, president of the Debtor, and members of the Katz family own about 50% of the outstanding first mortgage bonds (R. 53a). They acquired those bonds at a fraction of their face amount, while the Debtor was insolvent and the bonds were in default (R. 66a) and while they were considering the filing of a petition under Chapter X (R. 47a).

In addition to the first mortgage bonds, the Debtor, as of April 1, 1928, authorized the issue and sale of $300,000 principal amount of General Mortgage Bonds (R. 24a) and there are now outstanding bonds of that issue in the principal sum of $151,000, upon which the accrued and unpaid interest exceeds $200,000 (R. 6a). These bonds are secured by a second mortgage upon the hotel (R. 25a).

The hotel is leased to Kaber Corporation, a New Jersey corporation, under a lease made September 1, 1940, for a term of twenty years at a rental of either 25% of the gross income or $27,000 plus taxes, insurance, etc., whichever is greater (R. 28a, 29a, 48a).

The hotel shows a profit before interest on its funded debts (R. 49a). In fact the gross income for some years was about $600,000 a year; and the taxes, water rates, insurance, etc., amount to only about $60,000 a year (R. 29a).

The hotel is carried on the books of the Debtor at somewhat over $1,400,000 (R. 11a) and besides the hotel the Debtor has upwards of $115,000 in cash or its equivalent (R. 10a, 54a).

On December 8, 1944, the Debtor filed a petition for reorganization pursuant to Chapter X of the Bankruptcy Act (11 U. S. C. 501 *et seq.*) and on the same day the petition was approved as properly filed and respondent Aaron Smith was appointed trustee of the Debtor and its assets (R. 1a).

The petition had been authorized by the Debtor's board of directors on October 31, 1944, and was verified on November 9, 1944 (R. 8a). It had been under consideration by the management for a number of years (R. 47a).

In accordance with the direction of the District Court, contained in the order of approval, the trustee sent to all creditors and stockholders of the Debtor notice of a hearing to be held on January 12, 1945, to consider the qualifications of the trustee, as required by Sections 161 and 162 of Chapter X (11 U. S. C. 561, 562) (R. 13a).

On January 11, 1945, respondents Hurwith and Vidler filed separate answers to the Debtor's petition (R. 1a) and about that time moved to dismiss that petition by an order to show cause returnable on January 12, 1945, the day set for the hearing on the trustee's qualifications (R. 31a). In their respective answers (R. 14a), identical in every material respect (R. 31a), they charge that the petition was not filed in good faith (R. 21a). They aver that the interests of creditors and stockholders "would best be subserved" in an equity receivership action instituted by them in the Chancery Court of New Jersey and that a reorganization in the Chapter X proceeding was neither feasible nor possible (R. 21a).

On November 29, 1944, nine days before the debtor filed its petition, respondents Vidler and Hurwith and two other owners of first mortgage bonds of the debtor jointly commenced an action in the Chancery Court of New Jersey for the appointment of a receiver of the debtor pursuant to the provisions of the General Corporation Act of New Jersey (Title 14, Chap. 14 of the Rev. Stat. of New Jersey of 1937 N. J. S. A. 14:14) (R. 19a).[2]

It is the usual action for the sequestration, sale and distribution of the assets of an insolvent corporation. The

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[2] The pertinent provisions of the General Corporation Act are set forth in the Appendix to this petition.

receiver in such an action takes such title as the corporation had (N. J. S. A. 14:14-9). He may not sell encumbered assets free and clear of liens unless the lien is disputed and the asset would deteriorate pending the determination of its validity (N. J. S. A. 14:14-20).

Upon filing the complaint, the plaintiffs in the Chancery action obtained a rule to show cause, returnable December 12, 1944, why a temporary receiver should not be appointed (R. 51a).

The debtor's petition was filed before the return day of the rule to show cause, before the time to plead in the Chancery action had expired, and before any receiver had been appointed in that action.

On January 12, 1945, the court deferred the hearing upon the qualifications of the trustee and proceeded with the consideration of the motion to dismiss (R. 72a). *No notice of the answers or of the motion to dismiss was given to creditors or stockholders generally* (R. 96a, 98a).

The Securities and Exchange Commission, requested by the District Court to participate in the proceeding (R. 49a), urged a full and plenary hearing, including the introduction of oral testimony, upon the issues raised by the pleadings (R. 40a, 41a, 43a, 44a).

The District Judge overruled that request (R. 46a). However, he granted leave to George Zolotar, the attorney for the Securities and Exchange Commission, and J. Hector McNeal, attorney for the Debtor, to submit affidavits and adjourned the hearing to January 26, 1945 (R. 47a, 49a).

On January 26, the Securities and Exchange Commission again requested a plenary hearing but that request was also denied (R. 62a, *et. seq.*). It particularly requested the right to examine the answering creditors and officers of the Debtor for the purpose of establishing that continuance of the Chapter X proceeding would best sub-

serve the interests of public bondholders. It was the opinion of the District Court, however, that there were sufficient admitted facts contained in the pleadings and the affidavits and the arguments of counsel to permit a determination of the issues without additional evidence (R. 80a).

Despite the denial of an opportunity to adduce evidence by oral testimony, the record contains, in addition to the matters already stated, the following facts material to the issue of "good faith", as summarized in the brief of the Securities and Exchange Commission in the court below:

> "* * * The complainants in the Chancery Court include bondholders who recently acquired their holdings and who, according to the statement of their counsel, may be interested in purchasing the mortgaged property in the event of its sale (R. 52a, 68a).
>
> "Subsequent to the entry of the order of approval, which contained a stay of all other proceedings against the Debtor, counsel for the appellees informally advised the District Judge that in all probability a motion would be made to dismiss the Chapter X petition. Somewhat later, however, following conferences with counsel for the Debtor, the appellees' attorneys informed the District Judge that if they were appointed co-trustee and co-counsel to the trustees in the Chapter X proceeding, they would have no further interest in moving for dismissal. The attorneys stated in substance that such appointments would assure their clients a measure of control over the Chapter X proceeding and would assure themselves adequate fee allowances, thus placing both in a position substantially equivalent to that which they had reason to expect would exist in the State court action. This proposal was made in the presence of representatives of the Securities

and Exchange Commission who pointed out that in their view the appellees' attorneys, as representatives of bondholders, were not eligible for the suggested appointments because of the statutory requirements relating to disinterestedness (R. 64a-69a, 108a-109a).

"A few days thereafter, the appellees filed answers attacking the Debtor's petition as lacking in 'good faith' within the meaning of Section 146(3), (4), 11 U. S. C. 546(3), (4), and obtained an order to show cause why the Chapter X proceeding should not be dismissed (R. 14a-33a, 34a-37a). * * * Throughout the proceedings which followed, the Debtor displayed a purely passive attitude toward the challenge to its Chapter X petition and took no active part in the controversy (R. 62a-63a, 69a, 104a). In this connection, the record shows that the Debtor's management and equity interests hold approximately 50% in the amount of the first mortgage bonds (R. 53a). At the same conference in chambers at which the attorneys for the appellees, with the acquiescence of counsel for the Debtor, made their unsuccessful proposal for court appointments, Commission counsel stated, in emphasis of the need for a completely disinterested trustee, that preliminary investigation revealed the need for a searching inquiry into the facts and circumstances surrounding the acquisition of the bonds held by the management and equity owners for the purpose of determining whether grounds exist for equitable limitations or subordination of these bonds as against public holders (R. 66a-67a, 106a-107a). Thereafter, as stated by the District Judge, the Debtor's interest in the Chapter X proceeding lagged" (R. 72a, 74a, 78a).

Nevertheless, the District Court, relying upon this Court's decision in *Marine Harbor Properties* v. *Manufacturers Trust Company*, 317 U. S. 78, held that the

proponents of the petition did not carry the burden of showing that the interests of security holders would best be subserved in the Chapter X proceeding (R. 89a-90a). It also held that the proponents had not shown that it was reasonable to expect the effectuation of a plan of reorganization (R. 87a). Accordingly, on March 26, 1945, the District Court entered an order vacating its prior approval of the Debtor's petition and directing dismissal of the Chapter X proceeding upon approval of the trustee's accounts (R. 90a), thus relegating the Debtor's security holders to the equity receivership proceeding pending in the state court.

On April 13, 1945, Edward S. Ladin, also a first mortgage bondholder of the Debtor, moved to reopen the Chapter X proceeding on the ground that he had received no notice and had no knowledge of the answers and of the motion to dismiss and that his failure to attend the hearing on January 12, was due to his belief that the only matter which would come up for consideration was the qualification of the trustee to whose continuance he had no objection at that time (R. 93a, *et seq.*). Since the dismissal of the Chapter X proceeding was based on the failure to sustain the burden of "good faith" and since no opportunity to offer oral testimony had been given, although requested, Ladin asked for a plenary hearing upon the issues raised by the pleadings. The court denied the motion and an order to that effect was entered on April 30 (R. 109a). On the same day, an order was also entered approving the trustee's account and directing him to surrender the assets in his possession (R. 111a).

On appeal to the Circuit Court of Appeals, the orders of the District Court were affirmed. The *per curiam* opinion of the Circuit Court of Appeals contains no independent discussion of the issues involved but merely relies upon the reasons set forth in the opinion of the District Court.

## Specification of Errors.

The court below erred:

1. In holding that the proponents of the Chapter X petition had failed to sustain the burden of showing good faith.

2. In failing to hold that the interests of creditors would be better subserved in the Chapter X proceeding than in the pending equity receivership proceeding.

3. In failing to hold that it was reasonable to expect the effectuation of a plan of reorganization in the Chapter X proceeding.

4. In dismissing the Chapter X petition.

5. In failing to allow the introduction of competent proof, including oral testimony, in support of the Chapter X petition.

6. In failing to vacate the dismissal and reopen the proceeding on application of petitioner.

7. In directing the Chapter X trustee to surrender the assets of the debtor.

## Reasons for Granting the Writ.

The questions here presented are important and in some respects novel. There is presented a new phase of the question that has been a source of considerable trouble to our lower courts, namely, the meaning of "good faith" as applied to prior state court proceedings. It is re-

spectfully submitted that the term "good faith" as it relates to prior state court proceedings requires further definition by this Court. The questions here involved have arisen in other reorganization proceedings under Chapter X. (See *In re Biltmore Grande Apartment Building Trust,* 59 F. Supp. 1000, affirmed 146 F. (2d) 81 (7 C. C. A.); *In the Matter of Sheridan View Building Corporation,* 7 C. C. A. (not yet reported).)

Through a misinterpretation of this Court's decision in *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Company,* 317 U. S. 78, corporations in need of reorganization and their creditors have been denied relief under Chapter X of the Bankruptcy Act.

Chapter X and its predecessor, Section 77B, were enacted to overcome the inconveniences of the old, cumbersome and expensive equity receivership actions with their concomitant foreclosure proceedings and to correct the evils and abuses which frequently attended those actions (*Duparquet Huot & Moneuse Co.* v. *Evans,* 297 U. S. 216; *Securities and Exchange Commission* v. *United States Realty & Improvement Co.,* 310 U. S. 434). Congress has expressly provided that a petition under Chapter X may be filed notwithstanding the pendency of a prior proceeding. Section 256. In fact to a very large extent the right of creditors to invoke the remedy of Chapter X depends upon the pendency of a prior proceeding, state or federal. Section 131 (2) (4). It should be noted that nowhere does the Bankruptcy Act single out prior proceedings in state courts as distinguished from federal courts but that it speaks generally of prior proceedings regardless of the court in which that proceeding is pending.

Aside from the procedural and administrative advantages, a federal court in a Chapter X proceeding possesses powers and remedies which only a court of bankruptcy can exercise. The reorganization of a corporation gen-

erally requires a downward revision of its capital structure. Only a court, in a Chapter X proceeding, exercising the powers vested in it by the Bankruptcy Act can grant such relief. A court of bankruptcy in a Chapter X proceeding may not only modify the rights of creditors and stockholders but it may grant, the old corporation or the new corporation, absolute release from any and all obligations except those included in the plan of reorganization.

But no other court, in any other proceeding, may grant either relief without impairing the obligation of contracts. The equity receivership action may accomplish that result only by indirection, through the ceremonial formality of a sale at an upset price. Courts in equity receivership actions have no power to bind non-assenters and the corporation which is organized to take over the assets may, contrary to its intentions, become liable for the debts of the old corporation. See *Northern Pacific Ry. Co.* v. *Boyd,* 228 U. S. 482, *First National Bank* v. *Flershem,* 290 U. S. 504.

Purely in the interest of creditors and stockholders Congress in Section 146 (4) directed Bankruptcy Courts to deny approval of a petition if "it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding." There are times, when, as in the *Marine Harbor* case, a proceeding under Chapter X can grant no more than is available in a pending proceeding and when in the interest of economy and expedition the other proceeding should be permitted to continue and the exercise of jurisdiction under Chapter X should be declined.

In *Marine Harbor* case, there had been a reorganization in which the holders of certificates of participation, the only ones who had any interest in the property had agreed to appropriate the property for themselves if the debt

were not paid. Appropriation could be achieved more expeditiously and less expensively in the pending foreclosure action. All that this Court said in that case was that there was no need of another reorganization, the one previously adopted was sufficient and adequate.

Then, again, in a prior proceeding which has continued for some time, such progress may have been made towards the solution of a corporation's difficulties or towards a reorganization of that corporation that the assumption and exercise of jurisdiction under Chapter X might destroy what had already been done to the detriment of creditors and stockholders. It was not intended, however, that the paramount jurisdiction of courts of bankruptcy should be dependent upon the pendency of a state court equity receivership proceeding merely because it was prior in time.

However, contrary to the provisions of the act and through a misinterpretation of this Court's decision in the *Marine Harbor* case, there is a tendency on the part of some courts to refuse relief under Chapter X, even when the need of reorganization is beyond question, except upon proof that the prior proceeding is inadequate and that there is need specifically for the remedies of Chapter X.

## I

The decision of the lower courts in this proceeding is contrary to the express provisions of Chapter X and is in direct conflict with this Court's decisions in *Marine Harbor Properties* v. *Manufacturers Trust Company,* 317 U. S. 78; *Securities and Exchange Commission* v. *United States Realty & Improvement Co.,* 310 U. S. 434; *Duparquet, Huot & Moneuse Co.* v. *Evans,* 297 U. S. 216.

Despite this Court's repeated declarations to the contrary the District Court said: "But it was not intended

that Chapter X should supplant similar state proceedings" (R. 84a). In the opinion of the Court: "The dates of the filing of the respective petitions are controlling and the state court proceedings here antedate the federal suit by nine days" (R. 86a). With respect to the superior remedies and advantages of a proceeding in Chapter X the Court said:

> "An objective comparison of Chapter X proceedings and state court proceedings for the purpose of pointing out advantages in the former to show that the interests of the equity holders would be best subserved in the federal courts cannot be used to support a petition" (R. 83a).

The Court dismissed the Debtor's petition because:

> "There are no specific facts before the Court to evidence that the interests of creditors and stockholders would best be subserved in these proceedings rather than in the prior state court proceedings" (R. 84a).
>
> * * * * *
>
> "In fact, it appears from the record that if a plan of reorganization is effected it could consist of no more than an equivalent to a foreclosure of the rights of all creditors and stockholders other than the first mortgage bondholders. Whether the corporation be liquidated and the lienors paid off, whether foreclosure proceedings be taken and the property sold to the lienors, or whether the first mortgagees convert their bonds into stock as evidence of their ownership, the effect and net result would be the same—the first mortgage bondholders alone may participate in the proceedings and determine the ultimate form of their holdings. No showing has been made by the debtor corporation or the Securities & Exchange Commission, as the proponent of its petition, that this result

cannot be obtained in the suit in the New Jersey Court. (See N. J. S. A. 14:14, *supra.*)" (R. 84a.)

The District Court held that there was no need for relief under Chapter X because a reorganization, if necessary, could be effected in the Chancery action even though that result could be accomplished only by the use of the very methods which Chapter X was designed to supplant. The District Court thus held that the cumbersome and expensive prior state court equity receivership must take precedence over this proceeding under Chapter X.

Moreover the assumption by the District Court that adequate relief was available in the Chancery action is untenable.

Although the Chancery action was instituted in behalf of first mortgage bondholders the dismissal of the Chapter X proceeding leaves them without any adequate remedy and with no one to enforce or protect their rights.

The first mortgage bonds have matured and since payment in full is out of the question, the bondholders are entitled either to a sale of the hotel at a price satisfactory to them or else to the right to take the property and operate it for their own benefit. *Louisville Joint Stock Land Bank* v. *Radford,* 295 U. S. 555, 594; *Helvering* v. *Insurance Company,* 300 U. S. 216, 226.

Either relief is available in this proceeding. The court may either sell the property free and clear of all liens at not less than a fair upset price, or appropriate it for the benefit of those who have an interest therein, § 216 (10), 11 U. S. C.; § 616 (10); *Case* v. *Los Angeles Products Lumber Co.,* 308 U. S. 119.

No such relief, however, is obtainable in the action pending in the Chancery Court. The receiver in that action takes only such title as the corporation had (N. J. Rev. Stat. 14:14-9). The property, concededly, is not worth

and cannot be sold for an amount sufficient to pay and discharge the liens of the mortgages, nor can the receiver sell it free and clear of liens. That right may not be exercised except in cases where the lien is disputed and the property would deteriorate pending the determination of the validity of the lien (N. J. Rev. Stat. 14:14-20); *Bahler* v. *Robert Treat Baths,* 100 N. J. Eq. 525). The liens here are not in dispute and the property will not deteriorate.

The answering creditors recognized the limitations of that action and in the courts below urged that a substitute trustee for Franklin Trust Company could be appointed in that action and that that trustee could then institute an action for the foreclosure of the mortgage.

The fact is that this proceeding was dismissed not in favor of a prior action then pending but in favor of a new action about to be instituted, which also would be inadequate.

## II

There is also presented in this proceeding a question which is rather novel. The District Court declared that the effectuation of a plan for the reorganization of the Debtor could not resonably be expected because its liabilities were more than three times its assets. That statement the court made on the authority of this Court's decision in *Fidelity Assurance Association* v. *Sims,* 318 U. S. 608. It is undisputed that the Debtor makes a profit before interest on its funded debts and that it is possible, by a revision of its capital structure, to enable it to continue to function as a going concern. Whether it is unreasonable to expect that a plan of reorganization can be effected, because a debtor's liabilities greatly exceed its assets, is a question which it is respectfully submitted, should also be reviewed by this Court.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the decree of the Circuit Court of Appeals for the Third Circuit should be granted.

Dated, July 24, 1945.

EDWARD S. LADIN,

By DAVID M. PALLEY,
Attorney for Petitioner.